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Sovereign Defaults and How to Handle Them

*Global Economic Order vs. National Economic Policy
Interests on the Examples of Greece, Hungary
and Ukraine¹*



Summary

This study shows that since the Keynes-White dispute in the middle of the 20th century, the global economic policy thinking is clearly determined by White's views up until today. In the global monetary system, debt restructuring solutions are subordinated to the global economic order, and not to national economy policies, as shown by the recent examples of Greece, Hungary and Ukraine. According to this thinking, basically the debtor is held liable for imbalance and over-indebtedness. Obviously, the system cannot solve balance of payments problems between countries and the ensuing debt crises. The free movement of goods and capital is given an absolute priority. We show that out of the elements of the Keynesian system, only the introduction of creditor's liability as an instrument and the establishment of some sort of a supranational debt restructuring forum were proposed as a comprehensive solution after the 2008 crisis, besides some small-scale technical suggestions (e.g. the CAC). The reform proposals have not brought about any significant change in the management of sovereign defaults. In the euro area, after the 2010 sovereign crisis, the emphasis was laid on establishing the institutional background for the short-term financing of countries in debt crisis, rather than on genuine institutional reform of debt restructurings. And even in the worst of the crisis, the indebted countries are asked to implement more fiscal constraints and privatisation programmes as a prerequisite for further financing.

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Large international banks and investors and their home countries have no interest in institutional reforms: sovereign default remains a slow process with uncertain outcomes and even enormous costs. In our opinion, the institutional system of sovereign debt crisis management can only be reformed by the massive support of already existing international organisations. It would be a big step forward if IMF/EU abandoned their previous practice of protecting private investors and provided better safeguards for the interest of indebted countries and/or their own taxpayers.

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INTRODUCTION

Transparent, cost- and time-efficient corporate bankruptcy laws and practices have a long tradition in the developed world. Over the past one or two decades, private individuals' bankruptcies have also been appropriately regulated in certain countries. However, sovereign default still remains to be unregulated: a non-transparent process with unpredictable political and economic costs and a highly uncertain time course. Yet even in the case of conservative and prudent indebtedness, certain events may take place that drive a country into a debt crisis. In economic thinking, it is now a relatively wide-spread view that certain rapid and completely unforeseeable events might also happen that considerably worsen countries' debt positions.² In order to avoid long-term economic and political crises, the international community would need a bankruptcy mechanism that would help countries to recover quickly.

The subject has recently become topical with the 2010 sovereign debt crisis in the euro area. In 2014, financing difficulties in PIIGS countries (Portugal, Ireland, Italy, Greece, Spain) except for Greece, in Cyprus and in Hungary seemed to be resolved. However, this was when the political-economic crisis started in the Ukraine, on the other periphery of Europe. Let us note that, in our opinion, the subject still remains to be topical today. As we come to the end of the current financing period which, even in economic history terms, proved to be very persistently cheap, a new wave of sovereign debt problems can be expected in countries with long-standing current account deficit.³

In this paper, we would like to describe the management of sovereign default and the assessment of relevant reform proposals in light of an intellectual framework provided by a dispute that happened more than 70 years ago. This is the negotiation of John Maynard Keynes and his "opponent" Harry Dexter White. These two influential experts have greatly contributed to establishing the so-called Bretton Woods international monetary system. The outcome of their debate was determined mainly by the

distribution of power and interests at the time between the United States (White) and Great Britain (Keynes), and not by economic aspects. Also, this fact foreshadows one of the final conclusions of this paper, namely that debt restructurings are subordinated to the global order (i.e. the distribution of political and economic powers and interests), and not to national economy policies. After the collapse of the Bretton Woods system, no new international monetary system has been created; the current system can be seen as a continuation of the Bretton Woods system, as its institutions, the International Monetary Fund (IMF) and the World Bank (WB), and the US dollar are still dominating.⁴ That is the reason why it is important to outline the dispute between Keynes and White that serves as a framework for reconsiderations of debt restructuring practices and reform measures.

The remaining part of the study is organised as follows. Based on the literature after presenting the discussion between Keynes and White, we describe the development of the sovereign credit market, the definition of sovereign default and the current practice. We introduce a grouping of different reform proposals and evaluate the reform proposals and their criticisms. The above is supported by our Greek, Hungarian and Ukrainian case studies. Finally, we conclude.

KEYNES VS. WHITE; THE CONCEPTUAL FRAMEWORK

Keynes had looked into the problem of sovereign debt restructuring already in his book on the Versailles peace system (Keynes, 2000) that came after World War I. In agreement with Szakolczai (2017), all of Keynes's activities and works clearly point to his very last undertaking: creating the Keynesian order of the international monetary system. This system is considered as the extension of Keynes's General Theory onto the international platform and, thus, can also be named as Keynes's International General Theory. In Bretton Woods, the view of the United States was elaborated and represented by White. His view is considered just as important as it was eventually put into practice and has exerted its effects ever since.

Keynes summarised his pertinent views in two of his works: *Post-War Currency Policy* and *Proposals for an International Currency Union* (Keynes, 1941a; 1941b). The main elements of the Keynesian analysis, being, in our opinion, still valid today, are as follows:

- Ever since monetary systems exist, the current account problems between countries could never be solved, except in one or two shorter periods in time.
- It is a doctrinal illusion based on no experience that any *laissez faire*, *laissez passer* mechanism (free floating exchange rate, free movement of capital, deflationary processes, etc.) can create and maintain balance. It is not supported by any economic policy experience. Imbalances are persistent and generally lead to current account (debt) crises.
- The free movement of capital often reinforces imbalance: the financial capital flows from countries with persistent deficit (and thus in difficult financial situation) to persistently active countries. Speculative capitals are moving rapidly all over the world, ruining stable (real) business undertakings. All in all, capital flows in the market exacerbate problems caused by imbalance.

– Surplus countries are just as responsible for imbalances as deficit countries. Surplus countries supplement their insufficient domestic demand by export.

– Back then Keynes had already recognized the essence of what was later named in economics the Mundell-Fleming trilemma. A small and open economy cannot simultaneously maintain free capital movement, a fixed exchange rate and independent macroeconomy (monetary policy) (see Fleming, 1962; Mundell, 1963). As far as economic policy is concerned, this trilemma can be simplified to a dilemma: the priority is given either to the national economy conducive to the public good or to the global order (Szakolczai, 2017).

– In order to solve the above problems, a supranational institution is needed to establish and operate the international monetary system.

From a position of classical economic thinking, White puts the stability of the international monetary system first and favours the fixed exchange rate regime. According to his view, basically the debtor is held liable for the imbalance and over-indebtedness. At the same time, similarly to Keynes, White acknowledges that certain capital flows need to be controlled and fixed exchange rates need to be adjusted, if necessary (see Boughton, 2002). The overall aim of his proposal was to gain dominance for the United States in the Bretton Woods system, raising a country above others due to its economic and political weight. He mocks Keynes's proposal on a new international currency vs. his own "golden dollar" proposal, while his "dollar-standard" proposal later failed in practice. He envisaged the IMF to work like a bank and not like a clearing centre, where member countries collect the capital needed for the operation of the organisation, and the amount of the capital contribution determines the amount of the available loan and the voting rights of a given country.

The above economic policy dilemma is very topical in the euro area, and for making considerations about joining to the euro area. The mainstream economic thinking in the eurozone is that every country should maintain a completely free movement of goods and capital on fixed exchange rates, to the detriment of an autonomous economic policy that would help them to develop. So the international order and the free movement of capital are given absolute priority. This will be detailed later on through the example of how the Greek sovereign crisis was handled. Greece was not allowed, among others, to impose temporary restrictions on movement of capital and goods as an obvious means of stabilisation, they could only apply fiscal constraints and deflation. In light of the above, accession to the euro area is rather in the interest of those countries whose economies are in close harmony with the economies of the core countries in the euro area. At the same time, it assumes an almost identical level of economic development and same economic structures, as giving up the autonomous economic policy does not lead to conflict of interests.

Let me note that there are national economies that never surrendered the control over the movement of capital and goods. China is a good example for this, proving that a long-lasting economic catch-up can also be managed while having significant capital constraints at the same time. As for the Mundell-Fleming trilemma, the two elements China chose are the independent macroeconomy and the fixed exchange rate.

KEYNES'S PROPOSAL

Below you can read a summary of the main elements of Keynes's proposal for the Bretton Woods system, based on Szakolczai (2017).

1) The system should be established on international level as on the level of a country: an international banking system with an International Clearing Union. The prerequisite for this is the existence of a supranational currency that would be accepted by all member states' central banks, and inter-state accounts would be kept in this currency. This international money cannot be identical with any national currency, as it has a different function: it should be used for international accounting only.

2) The clearing centre does not need capital, as the surplus of surplus countries should equal to the deficit of deficit countries.

3) Every country has automatic overdraft facilities, so countries do not have a creditor-debtor relationship with another country, but with the clearing centre.

4) The basic principle of the system is that the surplus countries are just as responsible for imbalances as deficit countries. So the burden of adjustment should be shared by the two parties. It means that not only the deficit countries need restriction policies, but also surplus countries need expansion policies (increasing their own domestic demand).

5) Debtor countries should not pay interest to creditors, just a fee of 1–2 percent to the clearing centre. At the same time, creditors should not receive interest, but they should also pay the 1–2 percent fee to the clearing centre, as they are also responsible for the imbalance.

6) In the event a credit does not provide solution, the second proposed action is devaluation. The role of the Clearing Union in this is to prevent competitive devaluation.

7) If the latter still proves to be insufficient, then deficit countries have the right to impose import restrictions. According to Keynes's view, the expansion of the freedom of international trade can be temporarily reversible, if the situation requires so.

8) The next tool in line is increasing domestic demand in the surplus countries. If they do so and still have surplus for an extended period, the surplus should be spent on development credits for or investments in developing countries.

9) One of the major elements of the system is the control of international capital movement and the restriction of speculative capital flows.

10) Keynes acknowledges at the same time that if the above tools are all inefficient, then the given country appears not to have enough economic capacity to maintain the same standards of living, so restrictions are also needed.

The above tools are capable of preventing unsustainable imbalances. The most important elements of the above proposal (a national currency should not become the global currency; automatic and not capital contribution based overdraft facilities; the responsibility of creditor countries) were not accepted. At the same time, many points of the IMF founding treaty⁵ reflect the intellectual legacy of Keynes.⁶ However, the subsequent practice of the IMF has gradually moved away from it.

SOVEREIGN CREDIT MARKET DYNAMICS IN AND AFTER THE
BRETTON WOODS SYSTEM

In the Bretton Woods system (in the period after World War 2 until 1970) sovereign lending was made through intergovernmental or international institutions (World Bank, IMF), and it was a strictly controlled process. With the failure of the Bretton Woods exchange rate mechanism, from the 1970s, international private banks could enter this credit market. As the oil prices increased, oil producing countries made significant surplus; part of their savings was channelled by private banking groups to developing (oil importing) countries, financing their current account deficits. Long-lasting imbalances were essentially not corrected by neither economic, nor institutional mechanisms.

The significant debt stocks and risks that were built up in the meantime led to the sovereign crisis in 1980-1981. Some comprehensive proposals were made for the formal legal framework of sovereign debt restructuring,⁷ but eventually none of them were introduced. Measures for strengthening market processes were taken instead. The so-called Baker Plan made a more active lending activity of the IMF and the World Bank subject to market reforms, but did not deal with the institutional framework of debt restructuring. As the Baker Plan proved to be inefficient, the so-called Brady Plan was drawn up that laid the foundation for agreements on credit restructuring of developing countries. Besides partial debt relief, banks could exchange their unsecured dollar loans for longer-maturity and lower-interest bonds (and thus pulling out of financing), in many cases attaching special securities to them (for example, the oil reserves in Mexico). By issuing bonds for financing the debt, the secondary trade of these bonds were also built up, further increasing the share of market players in sovereign debt financing (Kamenis, 2014). These reforms basically served the creation of the sovereign financing market, but were not adequate to provide a comprehensive solution to debt crises, and what is more, made the system of sovereign financing even more complex and less transparent (for example, with the emergence of related credit default swaps and other derivative tools). The inefficiency of this system is aptly shown by waves of continuous sovereign crises (1994-1995: the so-called tequila crisis; 1998: crisis in Asia and in Russia; 2001-2002: crisis in Argentina).

In our opinion, purely market-based risk taking would be an important component of a healthy global financing system. However, institutional shortcomings make major private players' risk exposure asymmetric. Large negative risks are only virtual ones: in reality, these players undertake one large positive risk due to the lack of international regulations on and formal procedures for sovereign crisis situations. And in some specific cases, investment protection agreements between an indebted country and the United States also cover the subject of sovereign debt and thereby protect the interest of major American investors, so their real risk exposure is more limited.

Based on the literature in the sovereign credit market, a specific group of investors started to purchase the debt of countries coping with debt difficulties at a discount price; these are often called vulture funds and rogue creditors. Many times, these

creditors do not agree with debt restructuring agreements, they try to stay out, and continue to demand the full amount from the debtors.

Sovereign default and its settlement mechanisms boil down to two basic questions by certain authors (Schadler, 2015):

1) Legal technical procedure for restructuring: What shall be the legal and procedural framework of state debt restructuring when the debt of the country (with a significant share of international creditors) surpasses the country's debt servicing ability without serious disruptions of its economic and social order?

2) The responsibility of international assistance and creditors: In what situations shall the IMF or another international organisation provide financial assistance to a country in difficult situation and impose an obligation on bondholders to bear part of the loss?

It is apparent that the above components have been elaborated on in Keynes's proposal, as part of a single system.

THE DEFINITION OF SOVEREIGN DEFAULT AND ITS CURRENT PRACTICE

The commonly accepted definition of sovereign default is that a central government of a sovereign state does not fulfil its credit type obligations, or does not fulfil them according to the original conditions, and causes damage to creditors. Sovereign default is generally followed by a shorter/longer process where the parties involved exchange their existing state debt instruments (bonds, credit, securities, etc.), in the framework of a legal procedure, to new debt instruments. This is called restructuring, which has two main elements:⁸

- Debt rescheduling: extending the maturity of the debt. This is a form of debt relief, as the instalments are smaller (and prolonged in time).

- Debt reduction: the nominal value of the debt (the amount to be paid back) is reduced, which can be accompanied by reducing the burden of interest as well.

It is hard to make general comments on the direct causes of sovereign default; it is generally caused by several factors: excessive accumulation of debt, international lending cycles, sudden and significant decrease in the price of raw materials and crops, etc. The subject of creditor liability (there is no over-indebtedness without excessive lending) that had already been raised by Keynes was often highlighted by other prominent international financial experts as well (Sándor Lámfalussy, Joseph Stiglitz, for example). Market failure often happens in this area. And often there is non-negligible asymmetry (in strength, knowledge, information) between the sophisticated, large international providers of funds and the decision makers in the governments of developing countries. Market imperfections are exacerbated by bank capital controls that transfer financing risks (interest, exchange rate, maturity) to the debtors. As a consequence, a well-known phenomenon (the so-called "original sin") happens: a financing shortage in the local currency, foreign creditors are willing to provide funds in an international currency only. In segments with lower credit rating,

the main characteristic of international financing market is high volatility. Even smaller problems (emerging even in other regions or countries) trigger strong reactions to financing this circle of countries. Financing is totally independent of the financing needs of these debtors; what is more, it often happens that funds are pulled out when debtors need them the most (making the process very pro-cyclic). These problems all had appeared already in Keynes's analysis, but have been discussed ever since in international finances.

In the case of a loan provided to a sovereign debtor, the outcome of legal enforcement in court is uncertain, and state's assets would not, or would limitedly serve as an ultimate security for the repayment of the loans. It is important to show the possible costs of a sovereign default because these unwanted costs are responsible for the mechanism that allows for the existence of loans provided for sovereign states. A possible future international regulation on sovereign default should definitely take into account that incentives to repay loans should remain powerful enough.

Enforceability of a state debt is highly increased when the debt is to other states (even with more international influence) or when these states, referring to an investment treaty, take actions to protect their private creditors. In many cases, it was the IMF itself that strongly represented the interests of international creditors against debtors. A very good example for this is the Argentine crisis in 2001, where the IMF deliberately prolonged negotiations, extending the agony of the country (Stiglitz, 2007). Uncertain and long debt restructuring is the most important cost item in a sovereign bankruptcy. Finally, the Argentine government came to the decision that it is better for them to get out of the crisis on their own, without a new IMF programme, which then they accomplished successfully.

Another important cost item in sovereign default derives from reputation loss and its various economic consequences. One form of this is when private creditors, having no general legal enforcement tools in their hands, apply exclusion from financial markets, meaning they do not give new loans after bankruptcy. At the same time, it is empirically proven that sovereign default does not imply the final exclusion of the country from international financial markets. On the contrary, the memory of the markets is generally not too long. Especially after a successful debt restructuring process, markets do not discriminate, so lending to the given country can resume surprisingly fast. Exclusion from financial markets may appear in a less severe form, through the increase of loan costs, but its effects last for a short time, not more than 2 or 3 years (IMF, 2013).

Loss of reputation (confidence crisis) is manifest in the permanent deterioration of bilateral economic relations (between economic players of the creditor country and those of the debtor country), through the decline of working capital movement and trade. Freezing of foreign supplier credits is also an important channel to deteriorating trade relations. It must be noted that the breakdown of trade relations entail economic loss for both parties, so cannot be considered a lasting tool for sanctioning.

Last but not least, the negative impacts of sovereign defaults on the national economy and politics are also important to be highlighted. Effects on the domestic economy are most clearly manifest in the banking sector, especially when domestic banks provide significant funds to finance state debt — in these cases sovereign default can cause bank crisis. Sovereign default generally results in economic downturn, with unavoidable political consequences. Thus, sovereign defaults often lead to the failure of leading government officials and a change of government. Therefore, decision-makers might well be encouraged to postpone national bankruptcy out of own interests, even when bankruptcy would be a rational step on the social level (see Vidovics-Dancs, 2014). Let me note that it also implies compromising that leads to a situation where a completely weak country *de facto* loses its fiscal sovereignty.

INITIATIVES, PROPOSALS

In this and next chapter, we will group and evaluate the various reform proposals and their criticisms. Initiatives and proposals on reforming sovereign bankruptcies can be divided into two groups: 1) specific technical instruments that by themselves can improve the practice of national bankruptcies; 2) comprehensive proposals on a new system of institutions.

Specific prevention instruments

Experts attach particular importance to the so-called prevention instruments.

- For reducing the pro-cyclical impacts of international financing, the general use of the so-called GDP bonds. The credit costs of these bonds would move in tandem with the rate of economic growth. The costs would be higher in case of a rapid economic growth than in case of a declining economy.

- Another prevention instrument is tightening the rules for the transparency of national debts and Debt Sustainability Analysis (DSA). There are several international forums for the risk assessment of countries. The most well-known ones are IMF's DSAs. Also worth mentioning the OECD country reports that mainly reflect the (consensual!) value judgment of country export credit agencies. With an increased involvement of these forums, the information barriers to the debt situation of a certain country would be lowered. Public fund providers of OECD countries are already bound by requirements for debt sustainability, i.e. they cannot provide new funds to a country whose debt was assessed as unsustainable by the IMF. However, these rules do not apply to private players. It could be made obligatory that players who do not take sustainability signals into account should not receive any subsidies or international support.

- The strengthening of the framework of the so-called rules-based fiscal policies. A good example is the Constitution of Hungary, which includes debt rules also, so these rules are protected by a legal instrument of the highest level.⁹ The rules-based fiscal policies are regarded successful if they establish not only rules on procedures and transparency, but also institutional mechanisms for the enforcement of the rules.

– The reform of bilateral investment treaties can also strengthen prevention. Well in advance of debt problems, it would be appropriate to explicitly exclude the various forms of state debts from these treaties. In the current global liquidity glut, the negative market impact of these kinds of changes would be minimal.

Handling the “too little, too late” problem

Debt restructuring is a time-consuming process in which coordination between creditors might get difficult, potentially leading to the “free-rider phenomenon”; and private creditors liquidate their positions, and exposures and costs remain at public players and/or international institutions.

Establishment of agreements between creditors could be made much faster and more efficient by the general introduction of the so-called Collective Action Clauses (CAC), which would make the agreement of the qualified majority of creditors sufficient, and this agreement would be binding for the rest of the creditors also. According to a decision of the Eurogroup (an informal body of financial ministers in the euro area Member States), a CAC is required to be included in all new euro area government bonds issued after 1 January 2013.¹⁰

The other element in the solution for the “too little, too late” problem would be a rule that hinders public players and international institutions from bailing out private players’ credits. This could be achieved by setting Private Sector Involvement (PSI) as a condition for public and international institutions to be involved in the solution of the debt crisis or, in other words, public intervention should not be made possible without a bail-in (recapitalisation by creditors or release of the debt).

Comprehensive instruments

As is shown above, following major international debt crises, initiatives on a comprehensive institutional review of debt restructuring gain ground. The global economic crisis in 2008 gave a new impetus for proposals for the overall framework of sovereign bankruptcy, endorsed by international organisation as well. Proposals can be divided into two main groups: solutions based on either legislation or on arbitration proceedings. The supranational character, i.e. the limitation of national sovereignty, is more pronounced in the legislation-based approach.

Proposals based on legislation:

– IMF’s proposal on a Sovereign Debt Restructuring Mechanism (SDRM) in 2002/2003, which was given another push in 2012/2013 by the organisation, although IMF published it again only as an expert material (so-called “staff paper”) (IMF, 2013). The initiative was halted, mainly due to lack of support by the USA (Mooney, 2015). The proposal assigns a significant role to the IMF in the management of debt crises: 1) providing interim financing; 2) analysing debt sustainability, leading negotiations; 3) proposing a global solution, so sovereign defaults would be legally managed through one forum (Dispute Resolution Forum, DRF), similarly to the proposal

on arbitration. The proposal includes the compulsory use of CACs and an obligation for the creditor to suspend debt enforcement during negotiations on restructuring.

– In 2010, the sovereign crisis of the euro area led to the proposal on the European Crisis Resolution Mechanism (ECRM), outlined by the think-tank Bruegel, recommending a set of rules binding across the whole of the EU (Gianviti et al., 2010). Thus, it is a supranational proposal that consists of three pillars: 1) a legal institution to resolve disputes; 2) an economic institution to analyse debt sustainability and lead negotiations; 3) a financial institution to provide interim financing.

The essence of both proposals is that the agreement of the qualified majority (more than 75%) of creditors (considering all types of instruments) represents a valid decision binding for all creditors. By contrast, the Collective Action Clause represents a decision binding for all within only one instrument. In the European Union, only the CAC was introduced, the Bruegel concept was not.

We show that as a result of the 2010 sovereign crisis, the EU laid emphasis on establishing the institutional background for the short-term financing of countries in debt crisis, rather than on genuine institutional reform of debt restructuring. Therefore, countries' debt management remained within the already existing ad hoc framework, which is, as we will see, the reflection of international power relations. At the same time, as long as debt restructuring is underway, the interim financing of a given country is arranged from the then created funds (the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM)), if the country is cooperative enough. So, instead of expiring private creditor debts, these institutions step in as fund providers. Their fundamental philosophy is based on so-called "cash-for-reform programmes". In the framework of these programmes, they demand significant fiscal constraints and privatisation from crisis-stricken countries, further enhancing economic decline and social tensions. Another important aspect of EFSF and ESM is that there is a weak democratic control over them and both of them are closely intertwined with the private sector.¹¹

Keynes's situation analysis correctly describes the current international economic climate within the euro area. The above solution is clearly in the best interest of the "core" countries in the EU (to a large extent, Germany) that had a persistently positive foreign trade/current account balance. The previously mentioned crisis-stricken countries, most of them in the Mediterranean and some of them in the CEE region, were deficit economies in the years before 2008. The continuous deficit/surplus situations have built up a large group of debtors and creditors, and the whole system was financed by private financial institutions of core countries.¹² Therefore, the crisis basically derived from a competitiveness problem: the catching-up process in the EU stalled. This is important because it led to an inappropriate management of the crisis. European decision-makers demanded a significant fiscal adjustment from the countries in trouble, although the crisis-stricken Ireland and Spain had lower state debt and budget deficit than most of the countries in the euro area. Therefore, the whole process is morally questionable (e.g. Greeks being portrayed as lazy in the European press) as, for example, the external trade surplus of Germany, and thus the

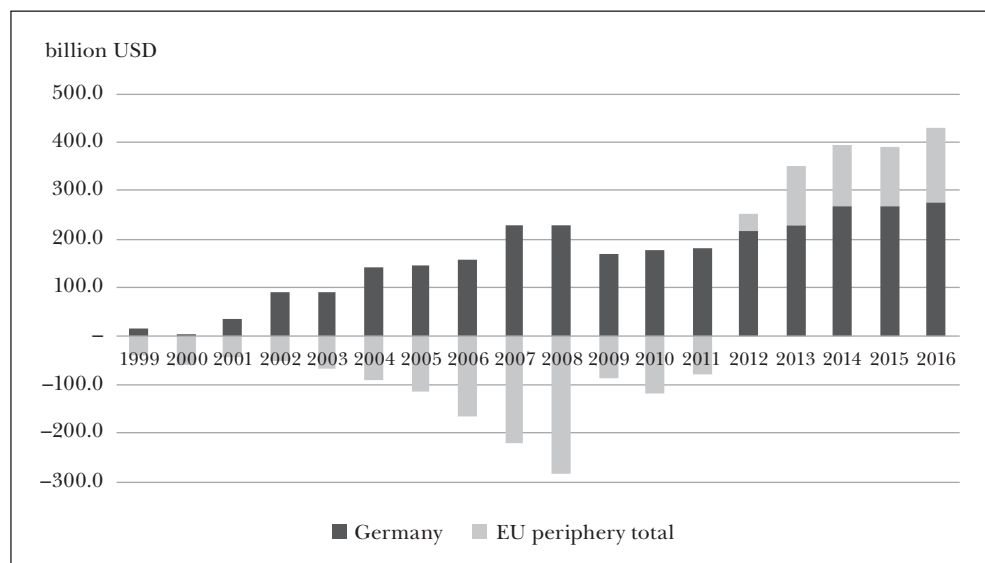
well-being of the Germans, was financed through *de facto* German loans by countries lagging behind (e.g. the Greeks). However, neither Germany, nor the EU has implemented any meaningful programmes to improve the competitiveness of Greece. This paper is not to make a judgment on the efficiency of various regional development programmes in the EU; however, it is a fact that there was no substantial catch-up made in the last 10 years, which is aptly reflected by the change in the relative economic development of periphery countries compared to Germany. The mean (un-weighted) per capita GDP of the periphery countries involved in the study was 42% of the same value in Germany in 2007. This mean percentage decreased to 38% by 2016. Changes by countries are shown in the graph below.

Table 1: Changes of GDP per capita expressed in EUR, in proportion to GDP per capita in Germany, between 2007 and 2016 (in percentage points)

Bulgaria	Czech Republic	Estonia	Greece	Spain	Italy	Cyprus	Latvia	Lithuania	Hungary	Poland	Portugal	Romania	Slovenia	Slovakia	Albania	Serbia
4%	1%	3%	-26%	-14%	-16%	-18%	0%	6%	-2%	3%	-7%	3%	-5%	6%	1%	0%

Sources: Edited by the author based on Eurostat

Figure 1: Balance on Goods and Services



Note: Periphery countries are considered to be all the countries indicated in the table above

Source: Edited by the author based on IMF

The Figure 1 clearly shows the expansion of the German export and that the periphery countries could only improve their external balance through significant internal constraints, as a result of which their economic catch-up was halted. From the perspective of the stability in the EU as a whole and the global economy, Germany was criticised for its current-account surplus, the issue was examined even by the European Commission. Germany's trade surplus already exceeds that of China on a sustained basis. *The Economist's* most recent article on the subject was published in 2017, in which the phenomenon was called as "The German problem". The article says that Germany is a country that "saves too much and spends too little" and it is "bad for the world economy". Germany's consumer spending in proportion to GDP is persistently lower than in other big economies (USA, Great Britain, etc.) and the country's investment rate is at a low level (The Economist, 2017).

As a result of the global debt crisis, the persistent deficit-surplus relationship made debtor-creditor relations tense.¹³ In this context, if policy makers of core countries had acknowledged that the demand of deficit countries had greatly contributed to their own countries' previous growth, and in turn they had shown some solidarity during debt restructurings, then the costs of the latter would have suddenly appeared in their own financial system, slowing down their own domestic economic activity. It clearly proves that voluntary loss assumption by the creditor is highly unlikely without an institutionalised form of creditor contribution, proposed by Keynes.

Based on the above it can be stated that the ESFS and ESM are given a similar role to that of the IMF, concentrating their activities on the euro area, in the best interest of the influential "core" Member States of the EU. The PIIGS countries and Cyprus were financed from these funds at the time of debt crisis. This paper, however, is not intended to detail the activities of these funds, because, as mentioned above, they have been created mainly in the interests of private creditors to provide interim financing.¹⁴ Let us continue then with the other type of comprehensive reform proposal.

Out of *proposals for an arbitration based solution*, let me highlight a concept embraced by NGOs called Fair and Transparent Arbitration Process (FTAP). Based on FTAP, the UNCTAD established a working group on Debt Workout Mechanism (DWM).¹⁵ This paper only mentions reform proposals from NGOs, but does not present them in detail. In our opinion, if a proposal, no matter how fair and efficient it may be, is not embraced by an international organisation and not integrated into any of their programmes, the chances for its implementation are practically zero.

The central elements of the "arbitration solution" are the establishment of an approved institution, conferred with decision-making powers (by both the debtor and its creditors) and, in the case of a country, the general use of the arbitration clause in all of the country's agreements associated with any future debt (bank loans, sovereign debt, loans provided by international organisations and bonds). One form could be a court operated by the UN. An advantage to this, compared to the IMF proposal, is that while the IMF itself is an active lender, the UN could act more independently in solving these types of problems. This approach does not require any change in inter-

national law. At the same time, it would serve as a replacement for the current debt settlement forums, the Paris and London Clubs.

In December 2014, the UN General Assembly established an ad hoc committee on sovereign debt restructuring, and the secretariat of the committee is provided by the UNCTAD.¹⁶ This committee does the expert work to reform sovereign debt restructuring.¹⁷ Nevertheless, there is still no forum for practical debt settlement.

All in all, every reform proposal would establish new procedural processes that would make state bankruptcy management and power relations smoother and more balanced. However, neither of these comprehensive reform proposals has been implemented.

CRITICAL VOICES: NO NEED FOR REFORMS

Based on the arguments below, IMF experts (Rediker and Ubide, 2014) consider the current practice appropriate from many aspects. The most common criticisms of the reforms, also reflected in the above-mentioned IMF material, are as follows:

1) Contrary to the critical rhetoric, restructurings were generally smooth over the past decades. Based on the data from the cited experts, the average duration of credit restructurings (from bankruptcy until the finalisation of restructuring) was 28 months.

In our opinion, an average of more than two years of uncertain financing can be considered significant, as in the meantime the economic players and the banking system cannot attract more sources, causing considerable negative impacts on the real economy. The IMF named two major debt crises (in Argentina and Greece) as outliers in sovereign debt restructuring, and removed them from the study sample. This rather questionable methodology resulted in a highly controversial distortion, as the two countries removed were the ones that underperformed the most, and not even pretence of impartiality could be maintained (see above the criticism on how the IMF handled the Argentine crisis).

2) IMF should draw more attention to risks rather than to reform proposals. IMF should name problematic countries and their financial risks in its various reports. It should exercise wider control over the development of country risks, and should not only deal with indebtedness of individual countries but also with cross-border financial processes, the unhedged currency position of the corporate sector, and various types of debts.

This argument is a bogus solution. In general, crises are hard to predict, and the reports of national banks and international organisations are not effective in holding back market processes. It is greatly demonstrated, for example, by the fact that central banks' financial stability reports had very weak forecasting power in terms of the 2007/2008 crisis (Davies and Green, 2010). Experience shows that such reports have a very limited moral impact on market players.¹⁸

3) For critics, the most painful solution is an initiative saying that in certain cases the condition of entry for the EU/IMF should be that private creditors take part of

the loss (bail-in). Critics say that this step would increase credit risks, which would require more IMF intervention in the future, and would definitely increase financing costs.

Our opinion about this piece of criticism is that in case this condition is *ex ante* attached to new credits in the future, the risk premium could be balanced by the impact made by creditors becoming more careful and undertaking lower financing risks only. The “search for yields” bandwagon effect could be more moderate and probably less likely turn into credit crises. One of the most important lessons learnt from recurring sovereign debt crises is that in the future a significantly lower level of indebtedness of a developing country would be desirable.

THE EXAMPLES OF GREECE, HUNGARY AND UKRAINE

In 2010, prior to the first debt restructuring, the Greek government owed EUR 310 billion to its private creditors, mainly “prudent” European banks and other financial mediators (big insurance companies, investment funds). In the first two debt restructuring processes, the troika (the European Commission representing the EU, the ECB and the IMF) provided EUR 250 billion to the Greek government; the largest part was undertaken by the EU and the ECB. However, Greece had to spend 92% of this amount to bail out private creditors and to finance its own domestic financial system (largely consisting of subsidiaries of European institutions), and only the remaining 8% could be spent freely by the Greek government. By 2012 it became clear that the Greek crisis cannot be solved without some degree of debt relief. Therefore, an agreement was made about the 50% write-off of the still existing Greek debt to private creditors, which proved to be insufficient for the following reasons: 1) by this time most of the foreign private creditors were bailed out by the funds of the troika; 2) the agreement affected the Greek national financial institutions primarily, so they went bankrupt, and Greece had to take out new loans to recapitalise them; 3) the already mentioned vulture investment funds refused to sign the agreement purchased debt instruments worth EUR 6.5 billion and took legal action to enforce their claim. Later on these funds compelled the Greek government to sign a special agreement, bringing substantial profits for them (Kamenis, 2014).

Despite the above-specified measures, the Greek debt still stood at EUR 317 billion in 2014, 78% of it owed to the troika, so from Community sources (from taxpayers’ money). Due to the sharp decline in GDP, the debt-to-GDP ratio considerably increased. Therefore, the troika did not manage to solve the Greek debt problem, only to bail out its European private creditors (Jones, 2015).

As a result of the crisis, real GDP in Greece fell by 23% from 2008 to 2013. The unemployment rate was as high as 27.5% in 2013. As was presented above, the first two rescue packages did not bring a solution to the financing problem in Greece, the country’s relative debt stock further increased substantially. The radical left-wing party Syriza, led by Alexis Tsipras, referred to the 1953 debt restructuring in Germany as the model for restructuring the Greek debt. The 1953 London Conference decided

on writing off half of all external debt of the Federal Republic of Germany (West Germany), and the repayment of the other half was made subject to the export income producing ability of West Germany. The London Agreement, which greatly contributed to rebuilding the German economy, was signed, inter alia, by Greece as well (Jones, 2015). There is no need to emphasise the geopolitical role of West Germany in the middle of the cold war.

By early 2015, it became obvious that, despite the required austerity policy, Greece cannot fulfil its debt service obligations without a more substantial debt relief. However, the troika demanded stringent austerity measures from the Greek government in exchange for maintaining financing. Prime Minister Alexis Tsipras had to make a choice: 1) either accepts the conditions of the troika, and goes against the main point of his political programme; or 2) goes bankrupt and handles the ensuing economic and social chaos. At this point he put the question to referendum in which 61% of the Greeks said “no” to creditors’ conditions. At the same time, more than 70% supported the euro. The outcome of the referendum did not influence the demands of the troika; the democratically expressed desire of the Greek people was ignored completely. After the referendum, Tsipras signed the third rescue package (new financing, with no debt relief) that included further constraints (lower pensions, higher taxes) and structural changes (labour market, privatisation) for the next three years. Significant internal tensions, a government crisis and early elections followed. In short, as a country lacking a prominent geopolitical role and having weak abilities to protect its own interests, Greece (with the sword of Grexit above its head¹⁹) was beaten by core countries’ ability to assert their own interests. We cannot speak about European solidarity at all. Let me note that the idea behind the troika’s firm steps was that any allowance given to Greece would have constituted a precedent for other (larger) Mediterranean countries in debt (Spain, Italy). The third rescue programme for Greece will be completed in the middle of 2018, but it is not expected to be the last one, as public debt in Greece is at a level of 180% compared to the GDP, so still considered to be unsustainable.

Hungary was the leader in the Central and Eastern European region in the catching-up process at the millennium. However, due to the change in the economic policy in 2002, fiscal policy has focused on short-term growth goals through stimulating consumption, which was accompanied by the rapid deterioration of economic balance and longer-term growth prospects. The growing consumption of the state and the private sector was largely covered by external funding. All the different economic players (central government, local governments, companies, households²⁰) raised a large amount of foreign exchange-based debt, a significant part of which was denominated in Swiss francs. By the time of the 2008 crisis, Hungary has become the most vulnerable economy in the region. Hungary was the second country (after Iceland) to receive financial assistance from the European Commission and the International Monetary Fund, totalling in some EUR 14.3 billion loans in the course of 2009 and 2010. The borrowing requirement was a fiscal adjustment, which was unsuccessful due to its strong procyclical impact (relative debt indicators deteriorated).²¹

In 2010, the newly elected government made sharp changes in the economic policy. Consolidation of the state budget with minimal damage to the real economy has become the primary aim. Another goal was to reduce the external vulnerability of the economy. Until early 2013, the Hungarian government maintained negotiations, with several interruptions, with the IMF and the Commission for further financing, but no new lending was made. On one hand, the IMF and the Commission wanted to force the Hungarian government for conditions (e.g. the withdrawal of the bank tax introduced²²) that it would not take, on the other the most difficult part of the financing crisis was resolved by 2013 due to the successful economic policy mix introduced between 2010 and 2013.²³ Finally, Hungary got out of the crisis on their own, without a new IMF programme like Argentina in 2002.

The Ukrainian crisis erupted in 2013. In February 2014, a bit more than one week before the IMF-EU rescue package, in the middle of the Ukrainian political and economic crisis (Kiev was in turmoil), the American vulture fund, the Franklin Templeton Investment Funds²⁴, specialised for debt crises, purchased sovereign bonds worth USD 1 billion from Russia, and thus became the owner of more than one third of Ukraine's foreign USD bonds. At that time, the above-mentioned investment fund possessed a non-negligible stock of Hungarian FX bonds, had built up its positions in the early 2010s: held 12% of the Hungarian public debt in its hands.

Let me note that the Bilateral Investment Protection Treaty between the Ukraine and the United States covers sovereign debts as well (Woods and John, 2014), protecting the interests of Templeton and similar large investors who are thus exposed to lower levels of risks.

Under the leadership of the IMF, Ukraine received its first financial aid package of USD 17.5 billion from international organisations in 2015. Following this, Ukraine's private creditors (except for the Russian ones) made an agreement on restructuring (20% decrease in the face value of bonds, the rate of bond coupons was set at 7.75%, and interest and capital payment was frozen for four years) (Reuters, 2015). The rate of the bond haircut was lower than market expectations, so the bonds' value was appreciated and their market value did not decrease, in spite of the haircut. Some experts say that Ukraine's geopolitical position and the structure of its creditors played a significant role in that the crisis management was relatively fast and efficient.

CAN REAL PROGRESS BE EXPECTED?

In view of the Keynes-White dispute, presented above, the global economic policy thinking is still clearly determined by White's views in today's world. In the global monetary system, debt restructuring solutions are subordinated to the global economic order, and not to national economy policies, as shown by the recent examples of Greece, Hungary and Ukraine. According to this thinking, basically the debtor is held liable for imbalance and over-indebtedness. Obviously, the system cannot solve balance of payments problems between countries and the ensuing debt crises. The free movement of goods and capital is given an absolute priority. Although the exam-

ple of China proves that a long-lasting economic catch-up can also be achieved while having significant constraints on capital movement at the same time. Based on our study, we conclude that out of the elements of the Keynesian system, only the introduction of creditor's liability as an instrument and the establishment of some sort of a supranational debt restructuring forum were proposed after the 2008 crisis, besides some small-scale technical suggestions (e.g. the CAC). The reform proposals have not brought about any significant change in the management of sovereign debt defaults.

We have shown that after the 2010 sovereign crisis in the euro area, the emphasis was laid on establishing the institutional background for the short-term financing of countries in debt crisis, rather than on genuine institutional reform of debt settlement. The then created institutions (the EFSF, and later the ESM) almost entirely lack democratic control, and their practices prove so far that they protect the interests of the "core" countries and their private creditors. And even in the worst of the crisis, the indebted countries are asked to implement more fiscal constraints and privatisation programmes as a prerequisite for further financing.

In our opinion, the institutional system of sovereign debt crisis management can only be reformed by massive support of already existing international organisations. Individual reform ideas, no matter how good they are, have no real chances for implementation if they lack support. A big step forward would be if IMF/EU abandoned their practice of protecting private investors and provided better safeguards for indebted countries and/or their own taxpayers. To this end, IMF should turn back to its Keynesian roots, the traces of which can still be found in the IMF's founding treaty.

Large international banks and investors and their home countries (the core countries) have no interest in institutional reforms. It is more beneficial for them if sovereign default remains a slow process with uncertain outcomes and even enormous costs. What is important for these actors is that there would be no real international solidarity and creditor liability, meaning that private sector involvement in debt restructuring (bail-in, haircut) would not be a general practice.

NOTES

¹ The author owes a debt of thanks to András Pórá for his valuable advice.

² See, for example, Taleb, 2012, who says that the world is characterised by major risks and limited forecastability. Out of the economic reasons for social vulnerability, he highlights over-specialisation, pointing out that although David Ricardo might be right in that efficiency is increased when every country pursues activities in which they have comparative advantage, but it also entails that the vulnerability of the national economy in question is highly increased. According to Taleb, the main deficiency of the Ricardian Theory, which still serves today as the basis of trade liberalisation and, thus, the global order, is that it does not take account of the swift and dramatic changes of market conditions; however, a society and a national economy should be prepared for these low-probability but high-impact events.

³ ECB's Financial Stability Review (ECB, 2017) also calls attention to this fact. The tightening of international monetary conditions, especially if it is accompanied by the strengthening of the dollar, can put emerging economies with internal and external imbalances into a difficult situation.

- ⁴ Of course, several elements of the system have changed (exchange rate mechanisms, the impact of the Chinese monetary policy, the euro area, international stability and investment institutions of the EU/Asia, etc.); however, we regard the current international monetary order as the continuation of the Bretton Woods system due to its influential institutions and the dominance of the dollar in it.
- ⁵ See <https://www.imf.org/external/pubs/ft/aa/index.htm>.
- ⁶ See, for example, Article I: “The purposes of the International Monetary Fund are... to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economy policy.”
- ⁷ See, for example, one of the first such proposals, made as a response to the 1981 crisis, to set up a formal legal framework: Oechsli, 1981.
- ⁸ For a detailed classification of sovereign bankruptcies, see the article of Vidovics-Dancs, 2014.
- ⁹ For details, see the article of Kolozsi et al., 2017, which describes the causal link between the provisions on public finances in the Constitution of Hungary and economic policy events after 2010.
- ¹⁰ See https://europa.eu/efc/collective-action-clauses-euro-area_en. As most of the Greek debt was issued according to national law, the Greek Parliament, supported by the troika, passed a law on the retrospective use of the above-mentioned clause, so the clause was attached to all debts issued according to the local law, which made it easier for the troika to replace private creditors.
- ¹¹ For example, EFSF and ESM cannot be obliged to make public any documents related to their operation. During the 2010 sovereign crisis, the troika (ECB, Commission, IMF) and, supposedly, the ESM as well had the restructuring programmes and the necessary financial audits devised by large international consultant firms (e.g. Oliver Wyman, BlackRock, Roland Berger, Pimco), giving them substantial business advantage, see CEO, 2014.
- ¹² Before 2008, private financial institutions of the core countries effectively channelled savings towards Mediterranean and CEE countries, indirectly financing their national, municipality, corporate and retail credit debts.
- ¹³ On this issue see, for example, Galgóczi, 2013.
- ¹⁴ For the historical background of the two instruments, see <https://www.esm.europa.eu/about-us/history>.
- ¹⁵ See <http://www.unctad.info/en/Debt-Portal/News-Archive/Our-News/Debt-Workout-Mechanism-First-Working-Group-meeting-Toward-an-Incremental-Approach-2072013-/>.
- ¹⁶ A/RES/69/247 Modalities for the implementation of resolution 68/304, entitled “Towards the establishment of a multilateral legal framework for sovereign debt restructuring processes”.
- ¹⁷ <http://unctad.org/en/Pages/GDS/Sovereign-Debt-Portal/Sovereign-Debt-Portal.aspx>.
- ¹⁸ A good example for the weak influence of national banks’ reports on the market is foreign currency lending in Hungary. The 2004 MNB stability report already indicated the problem, and in 2005 a special study on the subject was published by MNB. However, the real upswing in foreign lending in Hungary started only following this (Bethlendi et al., 2005).
- ¹⁹ Another debate is going on about to what extent could have Greece’s coerced exit from the euro area and from the EU (the Grexit) been feasible on procedural grounds and in economic terms.
- ²⁰ The issue of retail foreign currency debt see e.g. Bethlendi, 2011.
- ²¹ See for details of the above mentioned continuous downgraded process at: Matolcsy, 2008; Baksay and Palotai, 2017.
- ²² The Hungarian financial system was owned predominantly foreign, primarily Western European financial groups. The significant sectoral tax introduced resulted in serious conflicts of interest.
- ²³ The most important elements of the successful economic policy mix were the following: 1) Introduction of specific sectoral taxes (mainly in finance), which has a rapid fiscal balancing effect. 2) Already in the short term, a significant budgetary impact was made by the abolishment of the second pillar (the mandatory private pension) of the pension system. In 1998 the pay-as-you-go system was partially replaced by the mandatory private pension, therefore a part of the current contributions was payed to the private pension funds instead of the pay-as-you-go system. The resulting deficit of the pay-as-you-go system had to be financed by the budget, which kept the budget under pressure. Members of private pension funds

were reverted to the state system, so this current deficit disappeared, and the assets of the funds were also transferred to the state (nearly EUR 9 billion in value) improving the state's financial balance. 3) Strengthening the tools for whitening the economy (connecting retailers' cash registers to the tax authority online, tightening tax inspections, etc.), which raised the revenue of the budget without raising taxes. 4) Reducing work-related taxes, introducing labour market reforms and public employment: the government tried to build up the base of economic growth by maintaining and gradually increasing the level of employment. 5) At the same time, a spending reduction programme has been announced (basically affecting the public sector, some social costs and education). 6) Local government debts were consolidated by the state and the phasing out of household foreign currency loans has begun. 7) The financing role of EU funds has been strengthened.

- ²⁴ Templeton is not the only one adventurous investor. Less known ones who implement similar investment strategies are: Greylock Capital, Carlyle Group, LNG Capital, etc.

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